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No.— 559

In the Supreme Court of the United States

OCTOBER TERM, 1939

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JULIAN PRICE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

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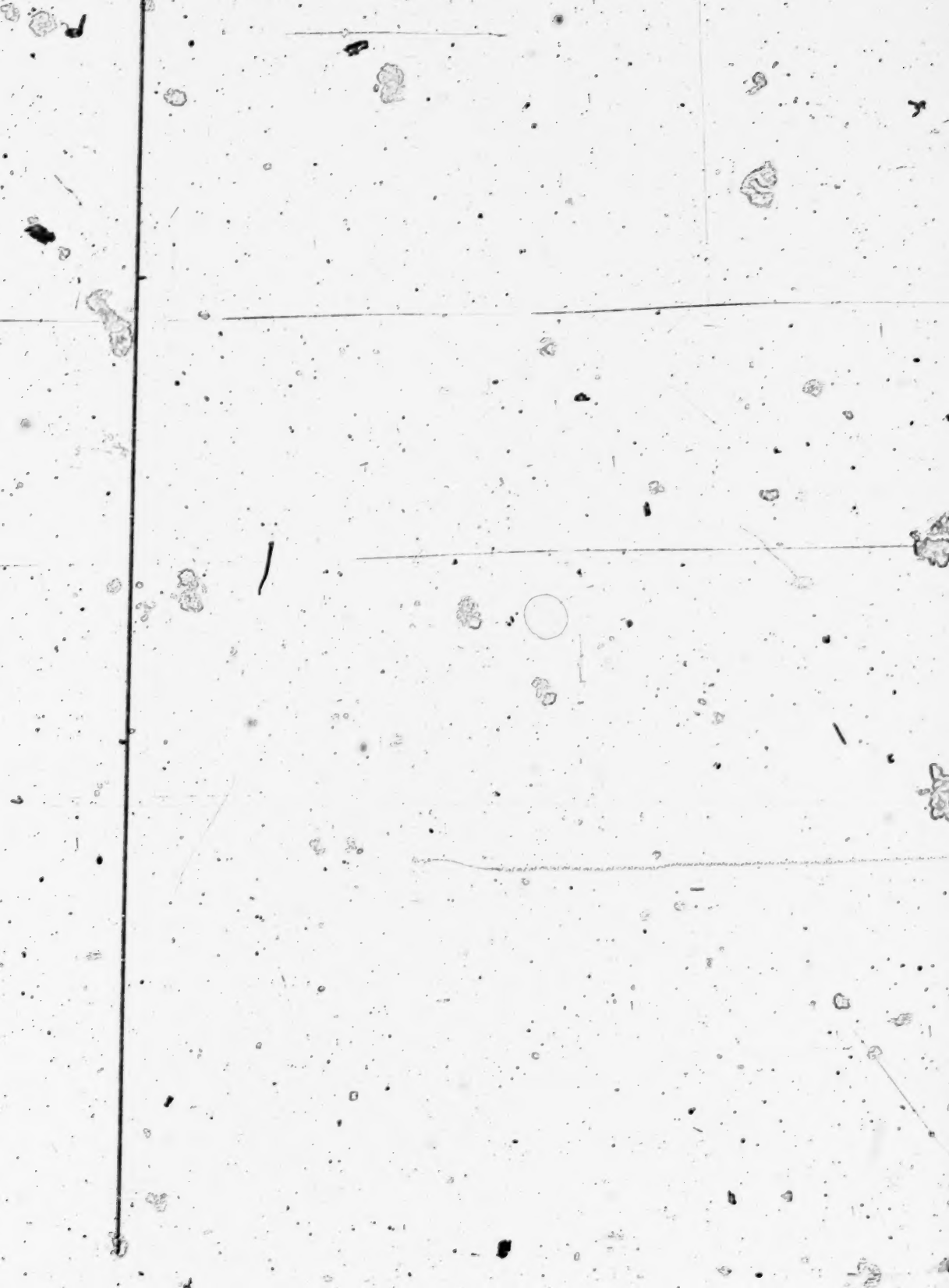

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The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fourth Circuit entered in the above cause on August 28, 1939, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (Tr. 17–29)[1] is not reported. The opin-

[1] Under the rules of the United States Circuit Court of Appeals for the Fourth Circuit there was no printed tran-

ion of the United States Circuit Court of Appeals is reported in 106 F. (2d) 336.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 28, 1939 (Tr. 65). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer, having agreed to guarantee a bank against certain losses, put his guaranty into bankable form at the request of the bank by giving it his own note for $125,000, endorsing a $125,000 note of a co-guarantor and furnishing collateral to secure both notes. In 1932, when the taxpayer's liability on his guaranty became certain, he gave the bank his own note for $250,000 in return for the two $125,000 notes, the new note being secured by the same collateral held by the bank as security for the old notes. The taxpayer made no payment on the $250,000 note during the year 1932.

The question presented is whether the taxpayer, who was on the cash receipts and disbursements basis, is entitled to a deductible loss for the year 1932 on account of his original note of $125,000.

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script of record in the court below, and the record has not yet been printed by the Clerk of this Court. All record references herein are therefore to the original transcript of record.

STATUTE INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(c) *Losses by Individuals.*—Subject to the limitations provided in subsection (r) of this section, in the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; * * *.

STATEMENT

The material facts as found by the Board of Tax Appeals (Tr. 18–25) may be summarized as follows:

The taxpayer is a resident of Greensboro, North Carolina. During the year 1929 he was president and a substantial stockholder of the Jefferson Standard Life Insurance Company, which com-

pany was a large stockholder and depositor in the Atlantic Bank and Trust Company of Greensboro. The taxpayer himself was also a stockholder of the Atlantic Bank (Tr. 18).

In September, 1929, the Atlantic Bank was merged with the North Carolina Bank and Trust Company. Under the plan of merger certain assets of the Atlantic Bank, called "A" assets, were accepted conditionally by the North Carolina Bank and certain other assets, called "B" assets, were pledged to that bank with authority to charge against the "B" assets any losses which might be established in realizing the "A" assets. As part of the merger the taxpayer and three other stockholders of the Atlantic Bank executed a guaranty agreement to the effect that, if the North Carolina Bank failed to realize a certain sum from the "A" assets within two years, they would make up the deficiency in an amount not exceeding $500,000. The agreement provided that any sums realized from the "B" assets were to be applied first to any losses occurring in the "A" assets and then to reimbursement of the four guarantors. The period for realizing upon the "A" assets under the terms of the guaranty was subsequently extended with the consent of the guarantors for an additional year, or until September, 1932 (Tr. 18–19).

In June, 1931, the president of the North Carolina Bank advised the guarantors that the "B" assets were not in such shape that the Bank could

use them to the extent necessary for banking purposes, and requested them to put their guaranty into bankable form so that it could be used by the bank to obtain credit. In compliance with this request, the taxpayer executed and delivered to the Bank his note for $125,000 and endorsed the note of C. W. Gold, another one of the guarantors, for a like amount. He also deposited collateral security for the payment of these notes. In consideration for the execution of his own note, the endorsement of Gold's note and the furnishing of the collateral, the Bank agreed that the taxpayer's liability under the guaranty should not be in excess of $250,000 (Tr. 20–21).

At the time of this transaction, the "B" assets were still pledged as security for realization on the "A" assets. In August, 1931, they were valued upon an appraisal at $529,947.44, an amount in excess of the guaranty made by the taxpayer and his co-guarantors. By the end of 1931, however, it became apparent that there would be some loss to the guarantors, although the amount of the loss was not definitely known and the guarantors had every reason to believe that they would receive substantial reimbursement from the "B" assets (Tr. 21).

In the early part of 1932, financial conditions in Greensboro took a turn for the worse, collections on the "A" and "B" assets declined and it soon became apparent that there was no possibility of

recovering anything further from the "B" assets. Consequently, in the latter part of March, 1932, the North Carolina Bank decided to make collection on the guaranty as to the "A" assets, and called upon the guarantors to make good their guaranty (Tr. 22).

The taxpayer thereupon arranged with the Bank to give the Bank his note for $250,000 in settlement of his own liability and that of Mr. Gold, upon whose note he was endorser. Upon the delivery to the Bank of this $250,000 note, the Bank marked "paid" and turned over to the taxpayer the two $125,000 notes which had been executed under the guaranty agreement. The $250,000 note was secured by the same collateral by which the two $125,000 notes had been secured. Both the taxpayer and the Bank considered this to be a final payment of the two notes given under the guaranty (Tr. 22–23).

In his tax return for the year 1932, which was filed on the cash receipts and disbursements basis (Tr. 18), the taxpayer deducted $125,000 as a loss sustained in this transaction, the amount of the deduction being the amount of the note which the taxpayer had executed as maker, as distinguished from the note which he had signed only as endorser.[2] The Commissioner of Internal Revenue

[2] The taxpayer deducted his alleged loss on Gold's note in 1933 and this deduction is not here in controversy. The court below stated with respect to this deduction: "As to the propriety of deferring the latter deduction until 1933, it

disallowed the deduction and determined a deficiency accordingly (Tr. 11–12). The Board of Tax Appeals sustained the deficiency (Tr. 25–30), but the court below reversed, holding that the taxpayer had realized the loss in 1932 and was entitled to the deduction (Tr. 53–64).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the taxpayer, on the cash receipts and disbursements basis, sustained a deductible loss under the guaranty agreement in March, 1932, when he discharged his obligation thereunder by the delivery of his promissory note secured by collateral.

2. In failing to hold that the taxpayer, on the cash receipts and disbursements basis, sustained no deductible loss under the guaranty agreement in March, 1932, when he discharged his obligation thereunder by the delivery of his promissory note secured by collateral.

3. In holding that the execution and delivery of the taxpayer's note and its accompanying collateral in March, 1932, constituted a payment of the taxpayer's loss under the guaranty agreement in "money or money's worth."

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appears that Gold died in 1932 and it was necessary for taxpayer to look to his estate for reimbursement. Not until 1933 did it become apparent that the estate was insolvent and that taxpayer could expect no reimbursement therefrom" (Tr. 56):

4. In failing to hold that the mere execution and delivery of the taxpayer's note and its accompanying collateral in March, 1932, did not constitute a payment of the taxpayer's loss under the guaranty agreement.

5. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision of the court below is in conflict with the decisions of the Circuit Court of Appeals for the Second Circuit in *Jenkins* v. *Bitgood*, 101 F. (2d) 17, certiorari denied, May 22, 1939, No. 892, October Term, 1938,[1] and in *Ferris* v. *Commissioner*, 102 F. (2d) 985, affirming, per curiam, 38 B. T. A. 312. Both of those cases were decided primarily on the authority of *Eckert* v. *Burnet*, 283 U. S. 140, with which the decision below is likewise in conflict.

In *Eckert* v. *Burnet*, *supra*, the taxpayer, who was liable to a bank as endorser of an unsecured note of an insolvent maker, took up the note during the taxable year by substituting his own unsecured note therefor. This Court held that, since the taxpayer was on the cash basis, he could not

[1] The taxpayer in *Jenkins* v. *Bitgood*, *supra*, moved this Court for leave to file a petition for rehearing of the petition for certiorari, asserting that the decision of the Circuit Court of Appeals for the Second Circuit in that case is in conflict with the decision of the court below in the instant case. The denial of that motion ~~on November 22, 1939,~~ would be however, ~~was plainly~~ justified for it had not been filed during the term of court in which the original petition had been denied.

deduct the amount of the old note as a worthless debt. The Court pointed out that the taxpayer had made no expenditure during the taxable year of cash or of property having a cash value and consequently, on the cash basis, had realized no loss and would realize no loss until the note was paid.

The *Eckert* case was the principal authority relied upon by the Circuit Court of Appeals for the Second Circuit in deciding *Jenkins* v. *Bitgood, supra.* There the taxpayer had sought to protect his investment in bank stock by purchasing depreciated bonds from the bank at prices in excess of market value, giving his secured promissory note in payment of the purchase price. When the bank stock subsequently became worthless, the taxpayer deducted as a loss not only the purchase price of the stock but also the difference between the purchase price and the market value of the bonds which he had bought from the bank, on the theory that this difference represented a contribution made by him to the capital of the bank to protect his investment in its stock. The court, while holding that this difference was a capital contribution, nevertheless denied the deduction on the ground that, on the cash basis, no deductible loss would be realized until the purchase money note was paid. Relying on the *Eckert* decision, the court pointed out the difference between the deductibility, on the cash basis, of a contribution to capital requiring the expenditure of cash or property having a cash value, and of a contribution consisting merely of a promissory

note, as yet unpaid. The fact that the *Eckert* case involved an unsecured note and a claim of deduction for a worthless debt, whereas the case then before it involved a secured note and a claim of deduction for an investment loss, was considered immaterial.

In *Ferris* v. *Commissioner, supra,* the taxpayer was liable as an endorser on a note of many years' standing held by a bank. During the taxable year, the taxpayer gave the bank his own note for an amount sufficient to discharge the original note, the bank credited the taxpayer's account with this amount, and the taxpayer then gave the bank his check in the same amount in satisfaction of the original note. The taxpayer was not permitteed to deduct the amount of the original note, either as a bad debt or as a loss, since he had in effect discharged the old obligation merely by the issuance of the new note, and therefore, on the cash basis, would realize a loss only when the new note was paid.

The principle underlying all of these cases is that, on the cash basis, no deductible loss can result from the execution of a promissory note, whether secured or not, until the note is paid. The decision of the court below, disregarding this principle, in effect obliterates the fundamental distinction between taxation on the cash and on the accrual bases of accounting. The execution and delivery of the taxpayer's note in this case in satisfaction of his

obligation under the guaranty agreement and the notes given pursuant to the guaranty agreement, did not in any way affect the taxpayer's financial position on a cash basis; he neither suffered a loss on an investment for which he had previously paid cash nor was he required to pay cash during the taxable year to satisfy losses from a transaction previously entered into. Only on the accrual theory of accounting was a loss sustained. But the taxpayer did not employ the accrual system of accounting. He kept his books on the cash basis, and Section 41 of the Revenue Act of 1932, *supra*, p. 3, requires that the net income shall be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer."

2. Because the decision below obliterates the distinction between the cash and accrual bases of accounting it will, unless reviewed by this Court, lead to serious confusion in the administration of the revenue acts. Determination of the question by this Court is important for the guidance of the Government and of taxpayers in future cases.

CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari should be granted.

ROBERT H. JACKSON,
Solicitor General.

NOVEMBER 1939.

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